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America's "efficient" asset markets seem like a perpetual motion machine that must go on cranking out wealth. Few people who benefit from it understand how the machine works, much less care about its economic, social, political and environmental costs. But sooner or later, its defects — including that much of the wealth it creates is just phantom wealth — will become obvious to everybody.

— Thornton Parker, *What If Boomers Can't Retire?* 2001

A U.S. HARD LANDING

According to Fed Chairman Alan Greenspan, the U.S. economy's slowdown in the second quarter was just a "soft patch" caused by the sharp rise of the oil price and "geopolitical" uncertainties. After all, the economy's growth is built on excellent fundamentals.

That the bullish consensus in the United States readily swallowed this message is hardly astonishing. But it was also fully shared by the Organization for Economic Cooperation and Development and the International Monetary Fund. Both are forecasting continuously robust U.S. economic growth.

At issue remains the familiar question of whether or not the prodigious fiscal and monetary stimuli of the past have been successful in launching a protracted, self-sustaining economic recovery in the United States.

What, exactly, does "self-sustaining" expansion mean? We would say it describes two key conditions: *first*, the complete absence of any artificial monetary and fiscal stimuli; and *second*, a change in the economy's pattern of growth from debt- and bubble-driven to employment- and income-driven.

Both conditions are not at all fulfilled. Tax cuts have ended. Individual tax refunds heavily bolstered consumer incomes during 2004's first half. Although the Fed is gradually raising its federal funds rate, it remains artificially low. Investors have been stunned in recent months by the quick, sharp drop in 10-year Treasury yields from 4.9% to barely 4%.

Business spending on high-tech investment has picked up, but there is reason to assume that investment projects have been pulled forward to benefit from the 50% accelerated depreciation, expiring at year-end and to be followed again by new weakness.

Mr. Greenspan likes to claim that, thanks to his brilliant policy, the U.S. economy experienced its mildest recession during the whole postwar period in 2001. If this was an achievement, it was more than offset, however, by the following unusually sluggish recovery.

It was, in fact, the U.S. economy's weakest recovery by far in the whole postwar period, compared to the growth rates of earlier postwar recoveries. Worst of all, though, was its badly skewed composition. In the past, personal consumption has on average accounted for 67% of real GDP growth. This time, its share was 109% of GDP growth. The other unusually large contributor was government spending, with a share of 33%.

It has meanwhile been recognized that the economy's transition from subpar growth toward self-sustaining expansion requires strong capital spending and hiring by businesses. The consensus is convinced that both are definitely on the way. A supposedly splendid corporate profit performance and highly liquid corporate balance sheets are the main arguments.

Careful scrutiny of the relevant facts leads us to a radically opposite assessment. *First* of all, as we shall explain in detail, the trumpeted profit boom of the past two to three years had the most miserable quality; and *second*, corporate balance sheets have hardly improved, if not worsened. Continuous strong debt growth compares with record low net fixed investment.

In 2000, capital spending exceeded the internal cash flow — accruing from depreciation allowances and retained earnings — by $308.9 billion. During 2003, the sector ran a financial surplus of $56.5 billion.

The consensus has hailed this development in corporate finance. They fail to see that this liquefaction of corporate balance sheets had a highly negative cause, owing overwhelmingly to the circumstance that business fixed investment spending has increasingly fallen short of current depreciations. To wit, it reflects a shrinking productive capital stock.

LOOKING FOR ECONOMIC TRACTION

The great issue is the "traction" that the aggressive pump-priming policies of the past few years have achieved. The first thing to see, in our view, is that pump priming of unprecedented scale has created an economic recovery that has fallen grossly short of the postwar recoveries with very little pump priming.

Looking for economic traction to pull the economy forward, we focus on four aggregates as the implicit key features of economic growth — business fixed investment, employment, household incomes and business profits.

Nonresidential fixed investment has picked up. In the second quarter of 2004, it was up a remarkable 10.7% year over year in real terms. For the consensus, this is compelling proof of final traction in investment spending. In our view, this increase should not be seen in isolation. The development of business investment over several years has been shockingly weak. In the second quarter of 2004, it was still 4.8% below its level in 2000. This compared with an increase in real GDP by 9% and in consumption by 12%.

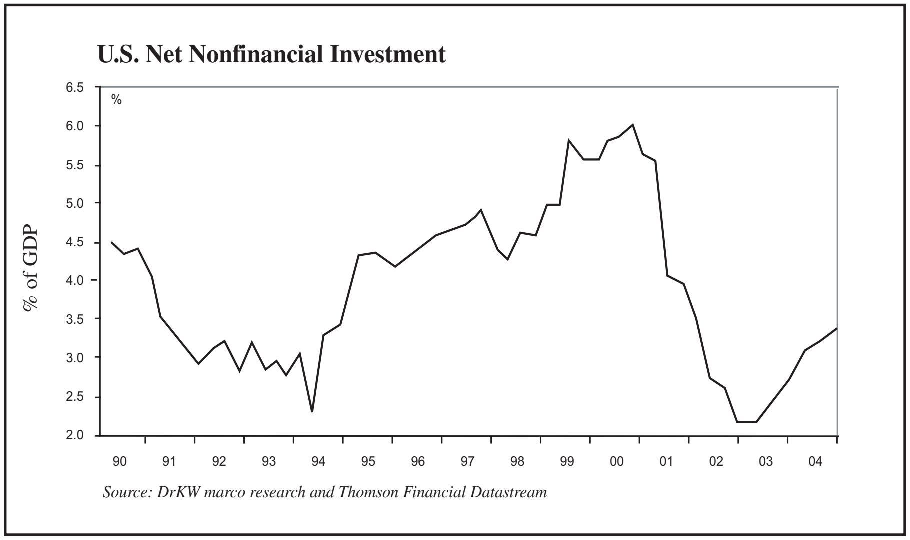
But could this not be the turning point toward the protracted investment rebound that the consensus is hoping for? The fact is that a tax incentive is at work, pulling investment spending forward as firms want to benefit from a 50% accelerated investment depreciation. To reap the benefit, actual installation of the machinery must take place by the end of 2004.

Our gloom about future capital spending in the United States has far deeper, fundamental reasons. In our view, the general narrow-minded obsession with driving up share prices led to an ingrained aversion to new capital spending as being supposedly detrimental to short-term profits and stock prices. In essence, Wall Street thinking and the famous new corporate culture are plainly anti-capitalistic. This is late and degenerated financial capitalism. The robber barons of yore were ugly figures with their recklessness, yet they were constructive for the nation by building new factories, railways, canals and so on. Wall Street's robber barons of today mainly build only phantom wealth through rising asset prices. As this boosts debt-driven consumption at the expense of true capital formation, these barons are destructive for the nation.

MANUFACTURING DEPRESSION

In reality, even the recorded investment numbers are too good to be true. Because business capital investment has drastically shifted toward short-lived high-tech investment, a rapidly growing portion of investment spending represents replacement of obsolete or worn-out capital stock, rather than a net increase overall. The result is an unprecedented wedge between the two components. According to official statistics, real net nonfinancial investment — the portion that expands the capital stocks — has plunged about 60% below its 2000 level.

No less ominous is the shift in the composition of investment spending between different sectors of the economy. Overall investment in information processing is up 20% since 2000, computers making up 84.3% of that. But investment in industrial equipment is down 12.4%, and transportation investment down even 19.2%. It seems a reasonable assumption that the investment spending on information high-tech is centered in the



economy's growth sectors, such as retail trade and finance. Investment in industrial equipment is no higher today than in 1995.

Manifestly, manufacturing is the key trouble spot in the U.S. economy. With a loss of almost 3 million jobs, from 17 million, since 2000, the sector accounts singularly for the overall job disaster. All other major sectors had rising employment. Not surprisingly, manufacturing stands out with the weakest investment spending.

It should immediately be clear that this extraordinary investment weakness is structural, not cyclical, and just as clear also should be its main cause: grossly overexpanded consumer spending, essentially at the expense of saving, investment, production and the trade balance.

Normally, such a vast spending excess on consumption would have fueled runaway inflation. But ferocious international competition diverted it to foreign, particularly Asian, producers. What lulled Mr. Greenspan, investors and the public into complacency was the persistence of low inflation rates. It did not occur to them that soaring imports and soaring asset prices are alternative outlets of credit inflation.

Hailing low inflation rates as striking testimony to the economy's health, policymakers and economists in America are at a loss to realize the enormous damage that the protracted credit excess has done and continues to do to the economy's whole structure. Above all, there appears to be zero understanding of the horrible damage inflicted by the monstrous trade deficit.

We come to the destructive relationship between the U.S. trade deficit and U.S. manufacturing. In our view, what has happened to U.S. manufacturing — with collapsing net investment and virtually 3 million job losses within three years — is comparable to the 1930s Depression. It is depression across the board in the whole sector — in net investment, employment and profits. Despite a recent strong rebound, manufacturing profits in the third quarter of 2004 were $94 billion, less than half their 1997 peak of $209 billion.

But what has been and keeps battering U.S. manufacturing? It definitely is not the oil price. It is a variety of domestic and foreign influences that have ravaged both business profits and national savings, and in their wake, business investment. Paraphrasing various remarks by economist John M. Keynes: *For enterprise to be active, two conditions must be fulfilled. There must be an expectation of profit, and there must also be a command over real resources that might be converted into capital investment.*

With this idea, Keynes expressed something that used to be a truism among economists since Adam Smith: Capital investment needs both profits and savings. The first thing to get straight is the definition of saving. By definition, it exclusively means saving from current income, implying that the saver releases physical resources from the production of consumption goods and services for the expansion of plant and equipment.

The physical fact is basic. Implicitly, a rise in capital investment cannot take place if consumers do not release real resources from consumption through saving a share of their current income. Conversely, when consumption takes a growing share of GDP, it implicitly reduces or crowds out capital investment. In essence, saving from current income sets the limits to potential capital formation. Confusing savings with money, which can easily be printed, American policymakers and most economists are blind to this elementary connection between saving and investment.

GETTING RID OF SAVINGS

Putting it bluntly, America's chronic low investment ratio has its primary cause in a chronically low supply of domestic saving. In a 1961 study by the National Bureau of Economic Research, "Capital in the American Economy," professor Simon Kuznet wondered *"why the ultimate consumers in our rapidly growing economy managed to save only a small portion of their income, and a proportion which, on a net basis, declined rather than rose, despite rising real income per capita."*

At the time, the U.S. personal saving ratio of disposable income fluctuated around 8% of disposable income. Compared to Europe, that was very low. In the United States, it was even temporarily above 10% in the 1980s. From then on began its long decline.

Kuznet made his above statement in response to the question of what was limiting capital formation. Was it the demand for capital or the supply of savings? His answer was, *"The approach which emphasizes the supply of savings seems more plausible and more fruitful as an analytical lead."*

In other words, a rise in consumption due to lower saving essentially leads to lower investment. We realize that this perception of a direct causal connection between rising consumption and declining capital investment diametrically contradicts the American consensus view, assuming the exact opposite relationship, that increasing consumer spending stimulates business investment. Conventionally, business capital investment is conceived of in America as "derived demand," derived from variations in consumer spending.

This presumption is known as the "acceleration principle," in contrast to the "multiplier principle," which says that rising investment spending has multiple direct and second-round effects on consumer spending. Both, by the way, are ascribed to Keynes. But the truth is that only the latter is from Keynes. The "acceleration principle," so dear to American economists and policymakers, is an invention of American Keynesians, who attribute it to Keynes. It is grossly flawed macroeconomics. In the first place, it begs a question that nobody asks: From where does the consumer get the income that he spends? In short, it comes primarily from business spending. Essentially, the incomes buying goods and services derive ultimately from their production. A little logic suggests that production is not determined by consumption, but consumption by production.

BUSINESS SPENDING RULES SUPREME

Unknown to most people, business spending in reality vastly exceeds consumer spending. True, the latter accounts for a far greater part of the reported gross domestic product. But this has its cause in how GDP figures are calculated. By no means do they represent total spending in the economy. The GDP calculation only counts the output of goods and services sold to "final users." The word "final" is important.

Consumer spending is considered to be in total for final use, entering the GDP calculation, therefore, in full. But in the case of business spending, the GDP statisticians distinguish between two different purposes — spending on myriad forms of "intermediate goods and services," such as raw materials and semifinished goods, and spending on finished capital goods.

Intermediate goods and services represent by far the greatest part of business spending. But counting only "final goods," the GDP calculation ignores them. Take the case of the automobile industry. There are the three large assemblers — GM, Ford and Chrysler — and numerous suppliers and subcontractors. Plainly, the production of the three assemblers is only the tip of the iceberg to the sector, yet it only enters the GDP calculation as the final product.

Business spending on finished capital goods is the much smaller part of business spending. But treated as "final goods," it is the only part that adds to GDP growth. The reason for this treatment of intermediate goods and services is to avoid "double counting."

Yet general ignorance of this differing statistical treatment has led to a gross misconception about the roles and the relationship of business spending and consumer spending in the macro process of production and income creation. The purchase and production of intermediate goods involve enormous expenses, far greater in most cases than labor costs, for example.

Thinking this through, it becomes clear that the conventional perception in the United States — that consumer spending is the demand component that governs business investment and economic growth — is badly flawed. It has been calculated that total business spending, taking the spending on intermediate goods and services into account, is two to three times larger than consumer spending. Business spending rules supreme.

Moreover, changes in business capital investment play a crucial role in the process of economic growth through their specific effects on employment, incomes and profits. There appears to be a widespread view that higher investment essentially reduces consumption. The fact is, rather, that — through the rising production of capital goods — it increases employment and labor income more rapidly than the outflow of capital goods.

We hasten to add that this was true throughout the more than 100 years of Industrial Revolution. This technology involved huge investments in plant and equipment, of which a large part required prolonged production processes. Companies needed numerous workers to meet the huge demand for those capital goods; and once these were manufactured and installed, other firms hired workers to operate them. This investment-driven economic growth was inherently associated with strong growth of employment and incomes.

Lack of capital investment is America's present key problem. That is one reason. The second one is that the new high-tech, for which corporate managers in America have an absolute preference, has very low labor and capital intensity. Between 2000 and 2003, employment by the manufacturers of computers and electronic products plunged from 1.8 million to 1.3 million.

A FEEBLE RECOVERY

As far as we can see, U.S. economic forecasts remain generally robust, regardless of the fact that the economic data flow continues to surprise overwhelmingly with unexpected weakness. Most forecasters apparently share the Fed's optimism that the U.S. economy is in great shape and poised for accelerating growth. We are mystified as to what they are watching.

Our own view about the U.S. economy's prospects is radically different. Plainly, the recovery that started in the second half of last year under the impact of prodigious fiscal and monetary stimuli has slowed. But contrary to the consensus perception of a brief downward blip, we see fundamental, long-term head winds behind this economic slowdown.

While there was a broad upward movement in spending, incomes and employment, it was much too feeble to become the possible foundation for a self-sustaining recovery. Past recoveries always started with a bang from pent-up demand. That, however, does not exist.

Yet worst of all is another aspect. To prevent a deeper and longer recession, the Fed responded with unprecedented monetary aggressiveness. The result, though, was the weakest recovery of all time. But even more important, in our view, is the realization that the resulting unprecedented credit excesses actually have driven the dislocations and imbalances of the boom to new extremes.

The somber reality is that this credit excess has devastated the manufacturing sector. It has devastated the trade balance, and it has devastated domestic savings. In our view, the three add up to virtually prohibitive conditions for a self-sustaining recovery.

STRANGLED CAPITAL INVESTMENT

It has been widely realized that self-sustaining economic growth needs a transition from asset-driven to employment- and income-driven demand creation. This, however, depends crucially on one condition: a sustained, strong rebound in business fixed investment.

With corporations apparently awash in newfound earnings and liquid assets, the bullish consensus had no doubt that U.S. business would promptly deliver strong capital spending and hiring, thereby providing the essential boost to income creation. To great disappointment, it has not happened. Instead, corporations have stepped up their stock buybacks.

The headline of an article trumpeted, "Cash-Rich Corporations Are Risk Averse." We do not buy this explanation. In our view, this perception of strong corporate balance sheets is grossly misplaced. It strikes us first of all that the pace of debt issuance, running at over $300 billion per year, is amazingly high, considering the slump in net fixed investment. Another remarkable fact is that most of that debt carries a "floating" rate of interest. Existing long-term debt at the same time is largely swapped into lower short-term rates.

First of all, we have to warn very strongly again against looking at aggregates. They obscure tremendous difference between sectors. As already pointed out, the financial sector is rolling in profits from prodigal speculation fostered by the Fed's artificially low short-term rates, while the goods-producing sector is systematically ruined by these policies.

Since 2000, manufacturing firms have been paying their dividends overwhelmingly with borrowed money, as reflected in big negative numbers for undistributed profits. In 2003, the firms of this sector paid $83.1 billion in dividends, against after-tax profits of only $21.2 billion. In contrast, firms in finance and insurance, gathering record profits, paid dividends of $61.4 billion, from after-tax earnings of $109.1 billion.

Again, we have to stress the same familiar point: Capital investment is heavily concentrated in the goods-producing sector. Ruin that sector, and you will infallibly see less and less capital investment in the economy. There is no other sector that can possibly compensate for the plunge of investment in manufacturing.

Business fixed investment has recovered, but from a prior slump. Its level remains abysmally low. Lacking a sustained, vigorous investment recovery, consumer spending is bound to slow. But there are four other strong head winds: *first*, fading wealth or bubble effects; *second*, cessation of income creation from tax cuts and individual tax refunds; *third*, heavy spending on consumer durables and housing that has borrowed from the future; and *fourth*, the rising oil price. Conveniently, the bullish consensus ignores the first three causes, which we consider to be far more important than the rising oil price.

SHARPLY SLOWER INCOME GROWTH

It was our basic assumption that sharply slower growth of the budget deficit after the cessation of the tax cuts would instantly slash income creation from this source. We failed to see the coming large individual tax refunds.

Disposable personal income in current dollars grew in the first half at a stellar annual rate of 5.7%. But in the three months ending August, it was down to an annual rate of 3.1%, including a large insurance payment for property damage from Hurricane Charley. Without it, disposable income increased only by 2.5% at annual rate, barely matching inflation. This compares to growth rates of 4.6% during 2002 and 4.2% in 2003.

The usual optimistic argument about consumer spending is that household balance sheets are in splendid shape, as the gains in house prices have vastly exceeded the steep rise in indebtedness. In other words, wealth creation has beaten debt creation, so the consumer borrowing-and-spending binge can continue.

Unfortunately, this compares apples and pears, because there is a crucial difference between the two financial components. The accelerating debt accumulation involves rapidly compounding interest expenses, while the rising asset values add nothing to the income of their owners.

Just as dubious is the source of this "wealth" creation. Asset values are determined by the capitalization of their income at current interest rates. Artificially low interest rates, like in the United States, intrinsically create artificially high asset values. The reality is bubble creation, not wealth creation. Equally dubious is how this "wealth creation" is calculated. It results from a statistical practice, conventional in several countries, to evaluate the total existing stock of particular assets as being worth the price of the last trade. This has no reasonable economic justification.

Last but not least, asset bubbles tend to have two major malignant effects on the economy: *First*, they foster runaway indebtedness; and *second*, they distort the allocation of resources. In the United States, the asset bubbles have drastically increased consumption's share of GDP, at the expense of investment and the trade balance.

Since 2000, mortgage borrowing has soared from $4.8 trillion to more than $7 trillion; that is, by more than

$600 billion per year. This compares with an increase during the prior 10 years (1991–2000) from $2.7 trillion to $4.8 trillion, or around $200 billion per year.

Overall household indebtedness is up from $7 trillion to almost $10 trillion since 2000. On this sum, we estimate, the American consumer has an annual interest bill of more than $500 billion; a sum, by the way, that vastly exceeds his current income growth.

NOTHING BUT UNPRODUCTIVE DEBT

Next, we must draw attention to another very important malignant aspect of the rampant debt inflation in the United States: It is virtually all for unproductive purposes, meaning that its use involves no income creation. The result is that the interest rate service compounds itself geometrically at an increasing rate.

Mr. Greenspan began a recent speech with this remark: "*In recent years, banks and thrifts have been experiencing low delinquency rates on home mortgage and credit cards, a situation suggesting that the vast majority of households are managing their debt well.*" How naive. For us, it is a foregone conclusion that in the United States, interests are generally no longer paid. Eager lenders, under pressure with the Fed's super-liquidity in the markets, readily capitalize the unpaid interests and roll them over.

The same is true, of course, for government borrowing and the vast borrowing by financial institutions for leveraged asset holdings. It seems reasonable to say that virtually all borrowing in the United States today is for unproductive purposes.

Wondering all the time about the use of America's continuous profligate debt growth, we make another simple calculation: $35 trillion of outstanding debt at an average interest rate of 5% leads to an annual overall interest bill of around $1.75 trillion.

To understand the problem, a comparison with the implications of productive debt is helpful. Borrowing for productive investment is self-financing. Over the investment's lifespan, the borrower gets his money back through depreciations. This cash flow allows him to repay his debts or to reinvest his money for the same or other purposes. Thus, the money once borrowed turns into an endless stream of investment, depreciations and reinvestment without any further increase in indebtedness.

Borrowing for unproductive purposes essentially ends up in gigantic Ponzi financing, meaning paying interest with new borrowing. Pointing out this problem of unproductive debt, professor Joseph A. Schumpeter wrote: "*The only conclusion that really follows is that the credit machine is so designed as to serve the improvement of the productive apparatus and to punish any other use.*"

PHONY WEALTH THAT IMPOVERISHES

It urgently needs a closer look at the widely hailed "wealth creation" through rising house prices. For sure, the owners feel richer. But in order to turn this feeling into higher spending in the absence of any income gain, they have to incur an equal amount of debts, using the higher house price as collateral. We do not quite see how anybody can regard this as wealth creation. Obviously, the higher spending is a one-time effect. The only lasting effect in this process is the higher debt.

From the macroeconomic perspective of resource allocation, this so-called wealth creation represents, in reality, genuine wealth destruction. To recall, for an economy as a whole, capital and wealth increase (only) when the community produces more than it consumes. But in the United States, the exact opposite has happened. Thanks to rising house prices the community consumes more than it produces. In the parlance of Austrian theory, this ranks as capital consumption.

Putting it differently and more bluntly: America's key structural problem is a protracted shift in its pattern of demand and resource allocation away from investment and toward consumption, strikingly reflected in the crashes of national and personal saving. Restoration of self-sustaining growth requires the economy's return to a better balance between these two components.

Just the opposite has happened. In order to escape from the consequences of the bursting stock market bubble, the Fed systematically created the bond and house-price bubbles, which have drastically aggravated this growth-impairing imbalance between consumption and investment.

A CATACLYSMIC SHOCK

For several months already, the data flow about the U.S. economy has been surprising with weaker-than-expected numbers. Yet there is a general flat denial that this could signal much worse than a "soft patch." Consensus forecasts remain as robust as before. It is probably widely realized that a weakening economy would be too frightening a possibility to consider.

What past experience makes clear, however, is that no early warning should be expected from the majority of economic forecasters. Past experience strictly suggests that American economists are either completely unable or unwilling to recognize a coming recession. The 2001 recession is only the last striking case in point. Neither the Fed nor the consensus showed the faintest inkling of its coming.

Comparing the U.S. economic situation today to that in 2000, we see a far weaker and far more vulnerable economy. That is the one key point. Another one is that monetary and fiscal pump-priming policies have spent themselves. And there is a third point: A totally unexpected new economic downturn will cause a general shock, perhaps cataclysmic, that will shatter Mr. Greenspan's ill-gotten reputation as the master of the monetary universe.

What could precipitate a U.S. hard landing? We see four main possible reasons: *first* sharply slower growth of consumer incomes; *second*, sharply lower business profits; *third*, increasing drag from the trade deficit; and *fourth*, the fading or bursting of the asset and borrowing bubbles.

Making this forecast, our primary consideration is that fiscal income and profit creation in the private sector is drastically subsiding due to sharply slower growth of the budget deficit. Its increase amounted to about $300 billion in 2001, around $260 billion in 2002, about $140 billion in 2003 and more than $400 billion at annual rate in the first half of 2004.

To make this point absolutely clear: When the *growth* of the annual federal budget deficit shrinks from around $250 billion to around $60 billion, the private sector — businesses and private households — suffers an income loss equal to that decline.

This effect has, indeed, occurred with a vengeance. According to the just reported GDP growth in the third quarter, disposable personal income has virtually collapsed to $53 billion, from $116 billion in the prior quarter.

THE TRADE BALANCE — THE GREAT INCOME LEAR

As we have stressed many times before, the single biggest drag on U.S. economic, employment and income growth is the gargantuan deficit in the external current account. When outlays for imported goods and services exceed a country's receipts from exports, the net payments to foreigners are lost to domestic GDP and income circulation dollar for dollar. Last year, the U.S. economy suffered a loss of about $530 billion through this trade and income leakage. This loss will exceed $600 billion this year.

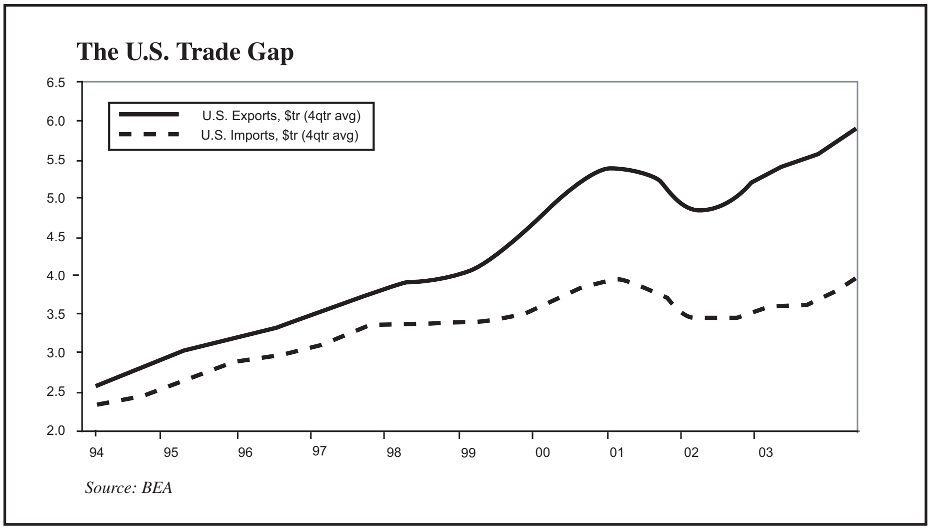
It has amazed us a long time already that American policymakers and economists flatly ignore the massive, protracted loss of domestic employment, incomes and spending through the trade deficit to foreign producers, hailing instead the downward pressure of cheap imports on U.S. inflation rates, allowing the Fed thereby to maintain cheap and loose money. It is abstruse economics.

What is worse, several reasons speak for the probability of a continuous increase of the deficit. It begins with daunting arithmetic. With imports of goods and services now around 40% higher than exports, the latter must grow by about 80% just to hold the deficit constant.

Our second major downbeat consideration about the U.S. trade balance is that the capital inflows associated with the monstrous current account deficit have not been funding investment-led economic growth that would drive increases in productive capacity. Fundamentally, the trade deficit has two main causes: a blatant lack of national

saving and business investment. Both are deteriorating.

Overall, the U.S. external imbalance is largely a manufacturing trade gap. But net manufacturing capital investment — the portion left over after allowing for replacement of worn-out capacity — is zero, if not negative. In light of these facts, employment and income creation from an improving trade balance look most improbable.



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POOR INVESTMENT PROSPECTS

Hope has been running high that sharply higher profits and drastic improvements in corporate balance sheets will induce businesses to boost their spending on plant and equipment. As already mentioned, what actually happened is a great disappointment. True, investment has recovered from its recession low, but it was an extremely narrow recovery in high-tech, which is not prone to create employment.

Overall spending on new plant in the second quarter of 2004 was still 23% below its 2000 level, and in manufacturing structures even 63%. From the perspective of employment and income creation, investment in plant happens to be the most important investment component.

Manufacturing is, actually, the worst performer in capital spending, both in structures and equipment, and certainly not by accident, it is also the worst performer in profits. For the second quarter of 2004, manufacturing shows NIPA profits of $94.8 billion. This compares to $166.3 billion in 2000 and $209 billion in 1997. The profit champions in the economy, not surprisingly, are finance, insurance and health services. But manufacturing is the sector that matters most for capital investment and foreign trade.

There are other reasons, though, that make us extremely skeptical of the currently cheerful U.S. profit story. The conventional explanation is rigorous general cost-cutting by businesses. First of all, we do not buy this argument. While cost-cutting may be a solution for a single firm, it is self-defeating if practiced in general, because firms cut each other's revenues this way.

In our view, the profit recovery in reality had entirely different causes. Three were most important, and most obvious: *first*, surging inventory valuations from booming commodity prices; *second*, soaring gains from heavily leveraged financial speculation (carry trade, etc.), also widely played by nonfinancial firms; and *third*, large financial flows into the private sector from the soaring fiscal deficit.

Here are a few spotlights on the development of profits. They hit their low for the nonfinancial sector at $236.5 billion annualized in the fourth quarter of 2001, after $413.4 billion in 2000 and $508.4 billion in the 1997 peak. These profits recovered to $448.8 billion at annual rate in the second quarter of 2004.

At first, this seems like an unusually steep increase. But this is an annualized quarterly figure, from which profits are now sure to fall. It strikes us, by the way, that numerous profit announcements for the third quarter are accompanied by the cryptic remark — "after extraordinary items."

All the talk of the "highest profit margins in history" relates to profits with "inventory valuation," or in other words, statistical profits from commodity price inflation. These profits are, indeed, at a record level, in excess of $900 billion, compared to $759.3 billion in 2000 and $812.3 billion in 1997. But we do not think that corporate managers regard these statistical gains as genuine profits. Nor do we. For most firms, the reality is instead that rising commodity prices hurt their earnings.

A careful assessment further has to take into account that nominal U.S. GDP is up 40% since 1997. At the time, the $508.4 billion NIPA profits of the nonfinancial sector — without inventory valuation — equaled 6.1% of GDP. The $448.8 billion of the second quarter is 3.8% of GDP. The profit boom is another hallucination.

HOSTAGE OF THE CARRY TRADE BUBBLE

While the Fed has raised its federal funds rate from 1% to 1.75%, longer-term interest rates simultaneously went in the opposite direction. The consensus sees the positive rationale in quiescent inflation and inflation expectations.

Our rationale is different: The sharp decline in long-term rates has its primary cause in the Fed's continuous, extreme monetary looseness fueling a new wave of carry trade. Though its rate hikes have made the carry trade play more expensive, the spread between funding costs and returns, determined by the difference between short-term rates and longer-term bond yields, remains quite attractive, in particular when market participants perceive little or no risk of a rise in long-term rates, which would quickly destroy the market value of their highly leveraged bond holdings.

In essence, two reasons mainly have led market participants to discard any risk of rising long-term rates. One is disappointing economic news, and the other is Mr. Greenspan. They have realized that the Greenspan Fed is effectively hostage to the carry trade bubble.

Running into trillions of dollars and involving an enormous part of corporate and financial America, the pricking of this asset bubble would spell financial apocalypse for America. It would trigger a fire sale of unimaginable proportions in the bond market, with bond prices crashing and yields soaring. Mr. Greenspan must be desperate to avoid this. It implies further that a return to "normal" short-term interest rates in the United States is completely out of the question, even if rising inflation rates or a collapsing dollar would urgently demand it.

Manifestly, the potential bond buyers needed to accommodate the potential sellers involved in the carry trade will not exist when the day of reckoning arrives. Liquidity will disappear overnight. Be prepared for double-digit U.S. long-term rates.

In short, U.S. monetary policy is inexorably stuck with artificially low interest rates.

Intrinsically, a weakening economy should boost further carry trade in bonds, and thus lower long-term rates. But a new, outright economic downturn will come as a rude awakening from prior complacency. Earlier, we said it might cause a cataclysmic shock. In the first place, it would hurt the other two asset bubbles, housing and stocks, and also the dollar bubble. Altogether, this would surely generate general uncertainty and turmoil in the financial markets, affecting the bond market negatively, too.

It is for two reasons, really, the most vulnerable and the most dangerous bubble. It is most vulnerable because any rise in long-term rates will prick it; and it is most dangerous because this would trigger immediate collective unwinding of positions running into trillions of dollars. It could devastate the whole financial system. No responsible central banker would allow such a bubble to develop.

The big problem lies in the fact that with a usual leverage of 20-to-1, even minimal rises in bond yields may endanger the capital of a yield-curve player. Another big risk looms in a widening of credit spreads. Given the unusually low level of yields, many players have shifted to higher-yielding junk bonds. One of the results has been a drastic narrowing of the yield spread. With a weakening economy, these spreads would certainly widen again.

NEW DOLLAR TROUBLES

All of a sudden, the euro/dollar rate has broken out of the narrow trading range that has held since last February. Two things mainly appear to have triggered this breakout: shockingly bad news about the U.S. trade balance and persistently disappointing news about the U.S. economy. While the bullish consensus has seen a

burgeoning economic recovery over the year, we have seen the last gasps of the most aggressive pump-priming policies in history. This false perception of a sustained U.S. economic recovery was crucial in stabilizing and strengthening the dollar.

We stress this point to emphasize our view that the U.S. economy is much weaker and much more vulnerable than various official statistics make it seem. The Fed cushioned the impact of the bursting stock market bubble by manipulating new asset bubbles. Ultra-low short-term interest rates and the explicit promise to keep them there for a prolonged period initiated a stampede of financial institutions into the highly leveraged carry trade of bonds. The resulting artificially low long-term rates fueled a housing and mortgage-borrowing boom, which prolonged the consumer borrowing-and-spending binge.

While European policymakers and economists are forever fretting aloud about structural rigidities, budget deficits and slow growth, American policymakers and economists are forever boasting how wonderfully efficient and flexible their economy is. Zero or even negative national savings, a stupendous trade deficit, a burgeoning budget deficit — all these and any other imbalances and dislocations are "nonproblems." Exploding credit and debt in America is not a sign of excess, but a testimony of the financial system's extraordinary efficiency.

For years, it has been a constant theme in this letter that the U.S. inflation rate is understated by at least 1.5 percentage points per year through hedonic and other statistical magic, thereby grossly overstating real GDP and productivity growth. We note with amazement that a highly critical spirit like Bill Gross has only lately discovered this (cf "Haute Con Job," PIMCO *Investment Outlook*, October 2004). An active proponent of this manipulation has been Alan Greenspan, apparently because a low inflation rate fosters low interest rates.

With an eye on the euro/dollar rate, we want to stress that the monstrous credit and debt bubble in the United States, through years of overaccommodation by the Federal Reserve, has created an economy with an array of horrible and massive dislocations and imbalances that make a sustained recovery impossible.

The dollar got its strength through 2004 mainly from two sources: false optimism about the U.S. economic recovery bolstering private capital inflows and dollar purchases by central banks. As the false optimism and the associated private capital inflows break down, they unmask the dollar's weakness.

Under a system of truly free currency markets, the dollar would have collapsed long ago, forcing the Fed to tighten its reins. But the massive dollar purchases by the Asian central banks have prevented this. China's persistence in pegging its currency to the dollar traps other Asian countries into doing the same.

While accumulating dollar reserves, a central bank floods its banking system with central bank deposits acting as "high-powered" money. This, essentially, sparks a credit bubble that accelerates but also distorts economic growth. In China and the other Asian countries, the credit bubbles have their conspicuous effects in overinvestment in manufacturing and real estate and hyperinflation in asset prices.

In striking contrast, the central banks in Europe — and now the European Central Bank — are firmly opposed to such interventions. In their view, large interventions in the currency markets have too high a price in fueling uncontrollable credit excess. While Japanese politicians are already warning of interventions, European finance ministers have publicly discarded the euro's rise as a "nonproblem."

Fear of fueling a destructive credit bubble is certainly the first reason for their flat rejection of intervention in the currency markets. But there is a highly positive second reason. A rise of the euro against the dollar boosts domestic purchasing power and lowers business costs by cheapening mostly dollar-quoted commodities. In the past few years, this effect has vastly outweighed the harm of the rising euro to exporters. Typically, the Eurozone had a sharply rising trade surplus in 2002, while the euro soared against the dollar.

This has long been our own view. The proponents of currency intervention completely overlook the beneficial effects of a rising currency on import prices, and therefore on domestic purchasing power. What's more, we are of the opinion that exporters ought to possess the bit of intelligence necessary to take care of the currency problem by hedging operations.

For us, frankly speaking, the protracted pegging of the Asian currencies to the dollar is a certain road to a severe crisis in both regions, because, in essence, the central banks accommodate each other's credit and spending excesses.

CONCLUSIONS

There is now wide agreement that the world economy is bound to slow down from its recent splurge. It is easy to agree with this forecast. Far more important, however, are three other concerns: *first*, the cause of this economic slowdown; *second*, its degree; and *third*, its impact on different countries.

Strikingly, there is but one cause in discussion — the surge of oil prices. This is where our dissent begins. For sure, it is one reason affecting the whole world. Still, we think that the unravelling of the credit and spending excesses in the United States and China are of far greater importance, considering the key roles of the two countries as the locomotives for world economic growth over the past few years.

In the U.S. case, it is widely recognized that the economy's transition from subpar asset-driven growth to self-sustaining employment- and income-driven growth depends entirely on strong capital spending and hiring by businesses. In this letter, we have explained in great detail why we do not see any chance of this happening. The implication for the U.S. economy is clear: relapse into pronounced economic weakness.

Taking the optimistic consensus completely by surprise, it would probably send shock waves through the markets, primarily the dollar, stocks and housing. Though it would appear positive for the bond market, its underlying, extremely high leverage makes it vulnerable to turmoil in other markets.

The key point to see is that the dynamics of self-sustaining job creation and income generation have not taken over, while the past stimuli are falling flat.

The just reported numbers about GDP growth in third quarter are frightening. Unexpectedly slow growth of 3.7%, after 3.3% in the prior quarter, accrued from a steep fall in the deflator from 3.5% to 1.8%. Growth of disposable income slumped to $53 billion, from $116 billion in the prior quarter; and the personal saving rate plunged from 1.2% to 0.4%.

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